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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation	)	MM Docket No. 93-215
	)	
and	)	
	)	
Adoption of a Uniform Accounting System for Provision of Regulated Cable Service	)	CS Docket No. 94-28

REPORT AND ORDER AND
FURTHER NOTICE OF PROPOSED RULEMAKING

Adopted: February 22, 1994 Released: March 30, 1994

By the Commission: **Commissioner Barrett issuing a statement.**

Comment Date: **July 1, 1994**
Reply Comment Date: **August 1, 1994**

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I. Introduction

1. The Cable Act of 1992 was adopted by Congress based on findings that most cable television systems do not face effective competition within their geographic areas and that, in the absence of regulation, cable operators have undue market power.[1] The Act sets out specific policy objectives for this Commission, including promotion of a diversity of views and information, reliance on marketplace forces, encouraging expansion of cable system capacity and programming where economically justified, and protection of customer interests where cable systems are not subject to effective competition.[2]

2. Rate regulation under the Cable Act of 1992 applies only to cable systems not subject to effective competition. For these systems, the Act directs the Commission to prescribe regulations for ensuring that cable rates are reasonable, taking into account criteria such as the rates for cable systems subject to effective competition, system capital and operating costs, and advertising revenues.[3] Rate regulation authority is divided between the FCC and local franchising authorities: certified franchising authorities have primary authority to regulate rates for the basic cable service tier, and the FCC has authority, pursuant to a validly-filed complaint, to regulate other tiers of cable programming service.[4] Per-channel, per-program, and certain other offerings are generally not subject to rate regulation.[5]

3. The Commission began its implementation of the 1992 Cable Act with an initial Notice of Proposed Rulemaking, and established initial rules to implement the Cable Act of 1992 in

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[1] Cable Television Consumer Protection and Competition Act, Pub. L. No. 102-385, §§ 2, 3, 9, 14, 106 Stat. 1460 (1992) (Cable Act of 1992).

[2] Cable Act of 1992, § 2(b).

[3] Cable Act of 1992, § 3, Communications Act of 1934, as amended, § 623(b), 47 U.S.C. § 543(b). The statutory language differs somewhat for the basic service tier and other regulated cable programming services. Compare Sections 623(b) and 623(c) of the Communications Act.

[4] Communications Act, § 623(a)(2), 47 U.S.C. § 543(a)(2).

[5] Communications Act, § 623(b)(1), 47 U.S.C. § 543(b)(1).

the Rate Order.[6] The Commission adopted a benchmark and price cap approach to serve as the primary regulatory mechanism for setting initial regulated rates and for governing rates on a going forward basis. The Commission also concluded in the Rate Order that the benchmark/price cap framework might not produce fully compensatory rates in all cases, and accordingly decided to permit cable systems to establish rates based on costs pursuant to individual cost-of-service showings.[7] The cost-of-service approach was to serve as a backup to the benchmark/price cap mechanism which a cable operator could invoke if it believed that the maximum rate under the benchmark/price cap formula would not enable the operator to recover costs that it reasonably incurred in the provision of regulated cable services.

4. In the Rate Order we discussed the relevant statutory provisions and legislative history, and concluded that the use of the benchmark/price cap approach as the primary regulatory mechanism, and the use of a cost-of-service safety valve as a supplemental mechanism, for regulating cable services is fully consistent with the applicable statutory requirements.[8] We found, however, that the record in Docket 92-266 did not provide sufficient information to enable us to develop detailed cost-of-service rules for the cable industry. We accordingly indicated that general cost-of-service principles would apply for cost-of-service showings for the time being, and we initiated this separate proceeding by issuing a Notice of Proposed Rulemaking that invited comment on the adoption of cost-of-service goals and rules, and on the role that a cost-based approach to ratemaking should play in our regulation of cable service rates.[9]

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[6] Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, Rate Regulation, MM Docket No. 92-266, Notice of Proposed Rulemaking, 8 FCC Rcd 510 (1992) (NPRM); Report and Order and Further Notice of Proposed Rulemaking, 8 FCC Rcd 5631 (1993) (Rate Order); Second Further Notice of Proposed Rulemaking, 8 FCC Rcd 5585 (1993) (Second Notice); First Reconsideration Order, Second Report and Order, and Third Further Notice of Proposed Rulemaking, 9 FCC Rcd 1164 (1993) (First Rates Reconsideration); Third Report and Order, 8 FCC Rcd 8444 (1993).

[7] Id. at 5794, ¶¶ 262-64. See also 47 C.F.R. § 76.922 (b)(1).

[8] Rate Order, 8 FCC Rcd at 5794, ¶¶ 262-64.

[9] Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, MM Docket No. 93-215, Notice of Proposed Rulemaking, FCC 93-353, released July

5. We adopt today both a Report and Order and a Further Notice of Proposed Rulemaking. In the Report and Order, we establish rules implementing a cost-of-service alternative to our primary benchmark and price cap approach to setting regulated cable service rates.[10] We set forth regulatory requirements to govern cost-of-service showings to justify rates above levels determined under our benchmarks and price cap requirements. We adopt these regulatory requirements on an interim basis, pending completion of cost studies of the cable industry. These interim rules, which apply only in cases where the cable operator elects to rely on a cost-of-service showing rather than on benchmark/ price cap requirements, will apply to rates charged or to be charged after the effective date of these rules; as we indicated in the Rate Order, general cost-of-service principles will govern rates in effect prior to the effective date of these rules. Thus, to the extent that a franchising authority's examination of basic rates relates to both periods, it would apply the appropriate rules to each period. The Commission will take a similar approach to resolve cable programming complaints that cover both periods.[11]

6. We adopt today accounting and allocation requirements that will govern cost-of-service showings. In the Report and Order we also adopt procedures for emergency rate review based on a showing of special circumstances, and we adopt an Upgrade

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16, 1993 (Notice). We also sought comment on setting a productivity offset that would reduce allowable rates under the benchmark/price cap mechanism, and we undertook cost studies of individual cable companies.

[10] In a separate decision, the Commission is adopting significant modifications to the benchmark and price cap approach to setting regulated cable service rates. Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, MM Docket 92-266, Second Order on Reconsideration, Fourth Report and Order, and Fifth Notice of Proposed Rulemaking, FCC 94-38 (Benchmark Order). That decision does not alter our determination in the Rate Order to afford cable operators an opportunity to set rates based on costs.

[11] Subsequent cable programming service complaint proceedings or basic tier proceedings relating to rates while these interim rules remain effective will be determined in accordance with these rules if the cable operator elects to justify rates as cost-based. If the permanent rules differ from the interim rules, the permanent rules will apply to proceedings relating to rates after their effective date.

Incentive Plan on an experimental basis. Under this Upgrade Incentive Plan, operators will be given pricing flexibility and profit incentives to introduce new services and operate efficiently, while customers will benefit from greater assurance of reasonable, stable rates for existing services.

7. In the Further Notice of Proposed Rulemaking, we propose that these interim requirements become permanent; we propose a productivity factor that could be incorporated into the price cap mechanism governing cable service rates; and we solicit comment on a permanent upgrade incentive plan for regulated cable service. We also announce initiation of cable industry cost studies that will be used to develop average cost schedules for regulated cable services and equipment, and to evaluate whether we should require full competitive rate reductions for systems currently eligible for transition relief.[12] We solicit comment on rate of return prescription methodologies, and on proposed rules for an accounting system and for affiliate transactions.

8. The rate set in a cost-of-service proceeding will be the permitted rate, even if it is lower than the rate that would have been determined under the benchmark/price cap approach. Our requirements seek to assure that, in any individual case, rates based on costs will be reasonable for both operators and subscribers. Once a rate is established through a cost-of-service proceeding, the price cap mechanism will govern.[13] Although the rules we are adopting here do not foreclose a cable operator's presenting new cost-of-service data to justify a rate that exceeds the capped rate after a two-year period, multiple cost-of-service showings should be rare.

9. We have been mindful of the Congressional concern that we not replicate Title II common carrier regulation in regulating rates for cable operators. The primary benchmark/price cap approach does not impose the tariff filing, accounting, and cost support obligations accompanying the Title II regulation this Commission has applied to telephone companies. We also are permitting abbreviated cost showings for rate increases needed to support capital improvements such as network upgrades and

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[12] See Benchmark Order at II.B.4.b. The Benchmark Order provides for the reduction of rates, in most cases, by an amount defined by the competitive differential. Transition relief is allowed to systems owned by "small operators" and to systems charging low prices, pending completion of our study of the prices and costs experienced by these systems.

[13] See Benchmark Order at II.B.6.; see also parts II.C.2, XII.D., infra.

rebuilds.

II. Cost-Based Cable Rate Regulation

A. Regulatory Goals

i. Notice

10. In the Notice, the Commission sought comment on what regulatory goals should guide our development of cost-based rates for regulated cable service.[14] We reiterated our belief that the benchmark/price cap approach is the primary tool for regulating cable rates, and that cost of service should serve as a 'backstop' method of rate regulation to meet the needs of cable operators with unusually high costs. We stated that our regulatory requirements for determining cost-based rates should fairly balance the interests of cable operators and consumers, permitting cable operators to recover the reasonable costs of providing cable service and attracting capital, including the opportunity for reasonable earnings, while protecting consumers from paying inappropriate costs and unreasonable charges, and should produce rates that are fair and reasonable to both.[15]

11. We tentatively concluded in the Notice that our cost-of-service regulations should offer cable operators an opportunity to recover their legitimate costs of providing service in high cost areas.[16] We stated that we would endeavor to fashion requirements that give ratemaking recognition to all legitimate costs while preventing recovery in rates of costs that subscribers should not be required to pay. We sought comment on, and stated that we would consider, the present economic and financial performance and practices of the cable industry, to allow us to assess the financial and economic impact of our cost rules on the cable industry.

12. In the Notice, the Commission observed that the benchmark approach was designed to produce rates at or near competitive levels; we solicited comment on whether cost requirements should also be designed to serve that goal.[17] We also stated in the Notice that cost requirements should be based as much as possible on a pragmatic approach geared to a practical

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[14] Notice at ¶ 7.

[15] Id. at ¶ 8.

[16] Id. at ¶¶ 13-14.

[17] Id. at ¶ 10.

implementation by local authorities and the Commission, and that they should, to the extent possible, reduce administrative burdens on cable operators and regulators.[18]

13. Finally, we tentatively concluded in the Notice that our cost requirements should be tier neutral, in consonance with the finding in the Rate Order that a regulatory approach that produced a low-priced basic service but created incentives for cable operators to move programming to higher tiers was not desirable, and presented no advantages over an approach that was tier-neutral.[19]

ii. Comments

14. Most commenters agree with the Commission that cost-of-service regulation should serve as a backstop to the benchmark/price cap standard.[20]

15. Cable operators generally argue that the cost-of-service framework should not be guided by the goal of producing rates that approximate competitive levels, given that the cable industry has not been rate regulated since 1986 and that many operators have incurred costs that would not be recoverable under our proposed interim cost standards.[21] Michigan Committee and Municipals support the goal of approximating competitive rates,[22] but Connecticut does not believe it is possible to set "a priori rate levels" in a cost-of-service proceeding.[23]

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[18] Id. at ¶ 12. This regulatory objective was mandated by the Cable Act of 1992, Communications Act, § 623(b)(2)(A), 47 U.S.C. § 543(b)(2)(A).

[19] Id. at ¶ 11, citing Rate Order, 8 FCC Rcd at ¶ 195-197.

[20] See, e.g., Time Warner Comments at 2-4; California Cable Comments at 21-26. A list of commenters in this proceeding, including full names and the shortened names used herein, is provided at Attachment A.

[21] See, e.g., TMC Comments at 6-7; Comcast Comments at 15-17. See also BC Comments at 5 (this approach is result-driven and would be inherently circular). Other operators argue that such an approach would be unconstitutional. Continental Comments at 5; Viacom Comments at 7; TCI Comments at 14-15.

[22] Michigan Committee Comments at 3; Municipals Comments at 7-8.

[23] Connecticut Comments at 1.

16. Finally, cable operators generally oppose tier neutrality as a regulatory goal because they believe inter-tier inefficiencies would be created by the varying costs of programming.[24] Local authorities generally support the concept of tier-neutral regulation in the cost-of-service formulation because they believe it will prevent channel shifting from basic to higher tiers.[25]

iii. Discussion

17. Our cost-of-service requirements are designed to assure that operators are able to recover the costs of providing regulated cable service by giving ratemaking recognition to all reasonable costs while preventing recovery in rates of unreasonable costs. Thus they achieve the goal of assuring that cable operators can recover their reasonable costs of providing service in high cost areas; our cost-of-service regulations provide for streamlined cost showings, opportunities to challenge presumptive disallowances, and special procedures for operators facing financial hardship.

18. Our cost-of-service requirements are also designed to produce rates that approach as closely as possible those that would evolve in a competitive market, while still allowing the operator of a high-cost system adequate recovery. Rates set under the benchmark approach are designed to produce competitive rates based on an evaluation of the observed rates of systems subject, and not subject, to effective competition. Our cost-of-service requirements seek to exclude from rates any costs that exceed what would have been incurred in a competitive environment or that are not related to regulated services. Our analysis of allowable costs, together with options for operators to challenge presumptive disallowances, will allow into regulated rates all reasonable costs, and will disallow costs that would not be reflected in rates in a competitive market. Thus, the benchmark and cost approaches both seek to achieve competitive rates by different approaches -- one based on observed prices of cable systems, one based on actual costs.

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[24] Continental Comments at 79; COA Comments at 88 (noting that many costs are not tier-neutral, so that per-channel cost allocations would be skewed and would fail to reflect cost causation). But see Viacom Comments at 51 n.49 (setting cable rates on a tier-neutral basis alleviates concerns over possible cross-subsidization across regulated tiers).

[25] See, e.g., Municipals Comments at 8; Michigan Committee Comments at 3.

19. Our regulatory framework gorverning cost-based rates for cable service is designed to assure that we can carefully guage the impact of the application of our cost requirements in individual cases. Our cost requirements are presumptive, and operators can present evidence seeking to justify higher rates than would otherwise be permitted under our cost rules. We also provide for hardship showings. Thus, we can assure that application of our cost rules will not adversely impact the cable industry. Further, our cost and rate of return studies will help us determine whether we should modify our general rules to avoid any undue impact on the industry. Thus, as stated, the cost-of-service option provides a safeguard for the industry from possible adverse effects in individual cases of the primary, benchmark/price cap approach.

20. We adopt our goal of creating a pragmatic cost-of-service system geared to implementation by local authorities, this Commission, and cable operators. We have streamlined and simplified our cost requirements to the extent possible, including adopting a uniform reporting form and a streamlined form for small systems, and proposing a uniform accounting system for cost-based regulated cable service. We have also provided for streamlined filing and review for rate changes due to network upgrades. These actions serve our goal of reducing administrative burdens on cable operators and regulators.

21. We adopt the goal of encouraging infrastructure investment and development. The cost-of-service principles and requirements we adopt here should allow and encourage cable operators to invest in technology, achieve efficiencies, broaden their service offerings, and extend penetration. Further, we are adopting an Upgrade Incentive Plan on an experimental basis to encourage development and deployment of new technologies and new services. Finally, we adopt our tentative conclusion that tier neutrality should be maintained. Thus, we adopt the same cost-of-service requirements for both the basic and cable programming services tiers.

B. Regulatory Model

i. Notice

22. We sought comment in the Notice on what general standard should be used to set rates based on costs for regulated cable service; we proposed using traditional cost-of-service principles to determine cost-based rates for regulated cable service.[26] We noted that under traditional cost-of-service

[26] Notice at ¶ 16.

regulation, rates are set at a level to provide the company with a recovery of its expenses and a reasonable opportunity to earn a fair return on its invested capital.[27] At the same time, recognizing some differences between the cable industry and other rate-regulated industries, we sought comment on alternatives or modifications to cost-of-service regulation that might be appropriate for determination of cost-based rates for regulated cable service. We also sought comment on what transition elements, if any, we should establish to permit cable operators to adapt to a rate-regulated environment.[28]

ii. Comments

23. Commenters other than cable operators generally agree that the traditional cost-of-service model we proposed is appropriate. Utah and CFA explicitly support the Commission's proposal.[29] Bell Atlantic also supports traditional ratebase/ rate of return regulation because it believes this approach places cable operators on comparable regulatory footing with the local exchange companies while utilizing the Commission's expertise.[30] Georgia Cable disagrees, stating that the cable industry should not be subject to telco-like regulation merely for the sake of "regulatory parity."[31] Several parties argue that the proposed ratebase/rate of return formula contravenes the

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[27] See id. at n.18. Under the traditional cost-of-service formulation, the company's revenue requirement is equal to the reasonable expenses of providing service and a fair return on investment. Under the traditional formulation, $R = E + (V-d)r$, where R is the revenue requirement; E is expenses including operating expenses, maintenance expenses, depreciation and taxes; V is the value of the ratebase including plant in service and working capital; d is accumulated depreciation; and r is the rate of return, consisting of a weighted average of long term debt, preferred stock, and common stock.

[28] Id. at ¶ 22.

[29] Utah Comments at 8; CFA Comments at 3.

[30] Bell Atlantic Comments at 5-6.

[31] Comments of Georgia Cable at 2-6. See also Comcast Comments at 7-8 (traditional ratebase/rate of return approach would not fairly balance the interests of consumers and cable operators); Time Warner Comments at 8 (ratebase/rate of return regulation should be one of several options available to cable operators who choose cost of service).

Congressional directive to avoid replicating Title II regulation.[32] GTE contends, however, that Congress did not intend to prohibit the Commission from using any regulatory tools currently used by the Commission in its regulation of telephone companies.[33] TMC supports the ratebase/rate of return standard as long as it is tailored to the cable industry's particular cost and financial structures.[34]

iii. Discussion

24. After careful consideration of the record, we adopt the cost-of-service formulation specified in the Notice. This formulation permits the regulated entity to recover its operating expenses and a fair return on investment, while protecting consumers from unreasonably high rates. In addition, while we are adopting in this proceeding rules of general applicability as part of our cost-of-service formulation, in individual cost proceedings, we can and will tailor our requirements to accommodate the special circumstances of individual cable operators. Thus, the requirements we adopt governing costs operators may recover in rates for regulated cable service establish presumptive standards that operators may seek to overcome in individual proceedings. In addition, although the cost-of-service requirements we are adopting are designed to be consistent with the ratebase/rate of return formula that has traditionally been used in public utility regulation, we plan to implement that formula in a manner that is simpler and easier to administer than the telephone model. We have also provided for streamlined cost showings for network upgrades, and have established provisions to address any extraordinary situations where our cost standards could create severe economic hardship. Our cost-of-service requirements will therefore permit us to address in individual cases any special circumstances cable operators may face in moving to a rate-regulated environment.

25. Commenters provide no feasible alternative model, nor any persuasive arguments against the ratebase/rate of return model. We disagree with commenters who contend that the ratebase/rate of return model contravenes congressional intent

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[32] See, e.g., Time Warner Comments at 6; COA Comments at 3; Cablevision Systems Comments at 15. These commenters refer to House Report 102-628 at 83. Title II of the Communications Act is the statutory authority for the Commission's regulations governing telephone companies. Communications Act of 1934 as amended, Title II, §§ 201-228.

[33] GTE Comments at 5.

[34] TMC Comments at 8-9.

that we not replicate Title II regulation. Our primary approach to rate regulation of cable service, the benchmark/price cap approach, is not cost-based, and does not impose the concomitant regulatory burdens such as tariff and cost support obligations. The cost-of-service regulation adopted here is only a secondary approach. It is also a more streamlined approach than Title II regulation, requiring less detailed cost support and accounting, and imposing no annual or biannual filing requirements. Moreover, the Cable Act of 1992 requires that the Commission consider such factors as the cost of obtaining and transmitting certain types of programming, franchise fees, taxes, and a reasonable profit for cable operators.[35] Our ratebase/rate of return standard includes these factors, and thus implements, rather than violates, the statute.

26. While Congress was concerned that we not replicate Title II regulation, it did not intend that we produce a system that is far more generous to operators, and less generous to customers, than the result produced by the telephone model. The purpose of regulation in each case is to ensure reasonable recovery for the service provider, while protecting the interests of the consumer. We believe that the cost-of-service standards we are adopting will approximate the costs and rates of cable systems subject to competition. Inasmuch as cost-of-service ratemaking is a safety valve for cable operators who believe that rates set under the benchmark approach are insufficient for them, fair, traditional cost-of-service standards are appropriate.[36]

C. Procedural Issues

1. Frequency of Filing

27. We proposed in the Notice to limit the frequency with which cable operators could submit cost-of-service showings for the basic or cable programming services tiers, so that after a pending cost-of-service showing has been evaluated by the local franchising authority or the Commission, an operator could not present a new cost-of-service showing for some period of time.[37]

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[35] Communications Act, § 623(b)(2)(C), 47 U.S.C. § 543(b)(2)(C).

[36] We are accordingly rejecting most cable operator requests to include items in the ratebase or in allowable expenses that traditional rate regulation would not include, or to adopt valuation standards that would result in a larger ratebase and higher rates.

[37] Notice at ¶ 17.

28. Virtually all commenting parties agree that it is reasonable to set limitations on the frequency with which cable operators can submit cost-of-service showings for ratemaking purposes. Some local franchising authorities favor periods of two to three years,[38] while cable operators generally agree that a one-year period is sufficient.[39] Some parties endorse a waiver mechanism for mid-period filings if economic circumstances justify.[40]

29. We conclude that a period of two years is a reasonable frequency limitation. We believe that changes in both cost and revenue will be adequately reflected on this schedule. A two-year period also allows for the development of regulatory stability, and the reduction of regulatory burdens.[41] After setting initial regulated rates under either the benchmark or cost-of-service approach, absent a special showing, operators may not file a cost-of-service showing to justify a new rate for two years.[42] We are also adopting rate-setting procedures that

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[38] See, e.g., New Jersey Comments at 4 (two years); Michigan Committee Comments at 6; Utah Comments at 6; New York Comments at 8 (all three years). But see Connecticut Comments at 2; MCATC Comments at 3 (one year).

[39] See, e.g., BC Comments at 7; Eagle Comments at 1; Media General Comments at 13.

[40] See Time Warner Comments at 20; Georgia Cable Comments at 6 (provide mid-year rate adjustments for recently-completed rebuilds); Municipals Comments at 11; MCATC Comments at 3.

[41] We may find it reasonable, following a cost-of-service showing, to set rates that include a scheduled reduction or other adjustment; or we may establish rates that are not expected to change, other than under the price cap, pending subsequent cost-of-service showings. As indicated, after the cost-based rate (with or without prescribed scheduled adjustments) is set, our price cap mechanism will govern.

[42] This two-year period will be measured from the effective date of the rates set in a local or Commission decision. Some parties have urged that we create a special waiver procedure for operators experiencing extreme financial hardship. Our rules generally provide for waivers; see 47 C.F.R. § 1.4. In addition, we have provided for hardship showings in some cases. Accordingly, we find it is not necessary to establish special waiver provisions concerning frequency of cost-of-service showings.

will be available to an operator in emergency situations, described more fully herein.[43] This approach will lessen the administrative burdens of duplicative cost-of-service showings, while furnishing operators a reasonable opportunity to recoup the costs of providing regulated cable services.

2. Procedural Limitations

30. In the Notice we solicited comment on whether we should establish procedural as well as frequency limitations on the submission of cost-of-service showings to justify rates higher than existing rates; we asked, for instance, whether we should require a demonstration of special circumstances or extraordinary costs before we would allow a cost-of-service showing. We also sought comment on whether it was reasonable to assume that operators set rates in an unregulated environment at levels that are fully compensatory, and whether we should therefore limit operators' ability to choose cost of service to set initial regulated rates at levels above pre-regulation levels.[44]

31. Cable operators uniformly oppose any obstacles to their electing cost-of-service regulation, and dispute the presumption that existing rates are fully compensatory.[45] These commenters believe that cost-of-service regulation should be freely electable as a full alternative to our primary benchmark/price cap approach.[46] NCTA argues that the Commission may not, consistent with due process, establish cost-of-service rules that are designed to discourage operators from seeking to establish cost-based rates.[47] CATA states that cost-based regulation should be an option for all operators, not just those with the resources to conduct such a proceeding.[48]

32. Several commenters state that the Commission should make this option available only in extraordinary circumstances

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[43] See part X., infra.

[44] Notice at ¶ 18.

[45] See, e.g., BC Comments at 8; Continental Reply at 27-28.

[46] See, e.g., NCTA Reply at 5-7.

[47] NCTA Comments at 5.

[48] CATA Comments at 18.

because of the burden it would place on regulators.[49] Local franchising authorities generally believe that cost-of-service showings should be permitted only if: (1) existing rates prevent the operator from earning a reasonable rate of return on revenues from all services taken together;[50] (2) the operator has made a capital improvement of benefit to all subscribers;[51] or (3) the operator has experienced unanticipated special costs not arising from operational or financial mismanagement.[52]

33. We conclude that no "threshold" or further procedural limitation on the ability of cable operators to file cost-of-service showings is needed. We believe that the threshold created by the requirements we adopt today -- that operators may not, absent extraordinary circumstances, file more frequently than every two years, and that operators will be bound by the findings of the cost-of-service showing even if those findings result in a rate reduction and in refund liability -- will serve as an adequate safeguard against the filing of frivolous or unneeded cost-of-service proceedings.

3. Initiation of Cost-of-service Regulation by Local Authorities

34. Some local authorities urge the Commission to permit them to require further information of operators, and to initiate cost-of-service showings, if appropriate.[53] While franchising authorities are of course free to require supplemental information in the course of a cost-of-service proceeding, we will not adopt a provision that local franchising authorities can initiate cost-of-service proceedings or general data collections, because we believe any benefits that might be derived from such a provision would be outweighed by the cost, and could conflict

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[49] Utah Comments at 2-3; NATOA Comments at 7; Austin Reply at 4; Arthur Andersen Comments at 6-10.

[50] Austin Comments at 5.

[51] Michigan Committee Comments at 6-7.

[52] Municipals Comments at 13; Seaford Comments at 8.

[53] See, e.g., Connecticut Comments at 1 (permit local authorities to verify cost showings through detailed audits); Seaford Comments at 8 (permit local authorities to require operators to file annual ARMIS-like reports, thereby allowing local regulators to initiate cost proceedings preemptively when costs reach levels sufficient to justify the expense of a new proceeding).

with the statutory requirement to minimize administrative burdens of rate regulation.[54] Moreover, we believe that our primary benchmark/price cap approach to setting rates will assure that rates for regulated cable service are reasonable. Accordingly, we will not provide that local authorities may initiate cost-of-service regulation.

4. Cost of Service Form

35. In order to reduce the administrative burdens of cost-of-service regulation, we proposed in the Notice to require that cable operators electing cost-of-service regulation present cost-of-service showings for both the basic service tier and cable programming services tier on a uniform FCC-prescribed form and associated worksheets.[55] Cable operators and local franchising authorities generally support our proposal,[56] although Time Warner argues that the Commission lacks the required experience to design a suitable form.[57]

36. We believe that use of a uniform cost of service form holds several advantages. Use of a form will lessen administrative burdens for industry and regulators by providing uniformity in presentation and review of cost information. The cost of service form will provide a clear standard for the cost support required from operators, and permit easy comparison with previously filed information.[58] Accordingly, we adopt a form that operators seeking to justify rates based on cost of service are required to use.[59] We also adopt a simplified version of

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[54] Communications Act, § 623(b)(2)(A), 47 U.S.C. § 543(b)(2)(A).

[55] Notice at ¶ 19.

[56] See, e.g., Cablevision Systems Comments at 43; TMC Comments at 9; Michigan Committee Comments at 7-8; MCATC Comments at 5; New Jersey Comments at 3-4.

[57] Time Warner Reply at 7.

[58] We also require that cable operators submit with their cost-of-service form, FCC Forms 1200, 1210, 1211, and 1215 to show the rate that will be permitted under the benchmark/price cap approach.

[59] Contrary to Time Warner's contention, we have had significant rate regulation experience and are confident that we can design, and have designed, a suitable form. Form 1220 is the general cost of service form in hard copy; Form 1225 is the

this form, for use by small cable systems. The requirements for these forms are provided with particularity in the instructions for each form.[60] See also parts V. and VI., infra.

III. Required Cost Showing

A. Ratebase

37. Under traditional ratebase/rate of return principles, it is necessary to determine the allowable ratebase both to calculate the return or profit component of the revenue requirement and to compute the earned rate of return.[61] In this section we adopt an interim approach to valuation of ratebase for purposes of determining rates based on cost of service showings. Specifically, we adopt the used and useful and prudent investment standards to govern amounts that may be included in ratebase. We determine that tangible plant in service shall be valued at original cost, but that, where records of original cost are not available, we will permit valuation of tangible plant at the book value assigned by the acquirer of the system provided that the operator shows that book value reasonably approximates original cost. We also permit certain intangible costs to be included in the ratebase as described below: accumulated start-up losses,

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simplified version of the cost of service form, for small systems, in hard copy. We are releasing these forms in a separate document. The Commission will endeavor to make these forms available in electronic format. Operators may attach additional worksheets to explain form entries or unusual circumstances.

[60] For purposes of evaluating proposed rates in pending cost-of-service proceedings for the period that commences after the effective date of our new rules, we require that all cable operators with pending cost-of-service proceedings for any regulated tier file the cost of service forms that we are adopting with this Report & Order by . The deadline for filing this supplemental information is July 14, 1994.

[61] See Amendment of Part 65 of the Commission's Rules to Prescribe Components of the Rate Base and Net Income of Dominant Carriers, Report and Order, 3 FCC Rcd 26 (1987), Order on Reconsideration, 4 FCC Rcd 1697 (1989), remanded sub nom. Illinois Bell Tel. Co. v. FCC, 911 F2d 776 (D.C. Cir. 1990), decision on remand, 7 FCC Rcd 296 (1991) (Ratebase Order), aff'd sub nom. Illinois Bell Tel. v. FCC, 988 F2d 1254 (D.C. Cir. 1993) (Illinois Bell). Ratebase traditionally consists of plant in service, noncurrent assets, materials and supplies, and cash working capital.

customer lists, and franchise rights. To the extent that a certain cost is excluded from the ratebase under these standards, the operator is permitted to present evidence to overcome some or all of the disallowance by showing that these costs benefit subscribers.[62]

1. Used and Useful, Prudent Investment Standards

38. In the Notice, the Commission sought comment on costs that should be included in plant in service, the largest portion of the ratebase.[63] We tentatively concluded that we should apply the used and useful and prudent investment standards to the original construction cost of assets dedicated to regulated cable service to determine the costs that may be included in plant in service in the ratebase.

39. Of the parties that commented specifically on the Commission's proposal to adopt the used and useful and prudent investment standards, the majority supported the Commission's tentative conclusion.[64] The used and useful and prudent

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[62] Disallowance from the ratebase under our rules prohibits the operator only from recovering these costs from regulated ratepayers; our rules do not forbid an operator's recovering these costs from consumers of nonregulated services.

[63] Notice at ¶ 32.

[64] See, e.g., New Jersey Comments at 6; Michigan Comments at 13; Municipals Comments at 18-19; Seaford Comments at 10; Utah Comments at 13. Austin further asserts that no investment should be recognized for the purpose of establishing regulated rates unless the benefits to subscribers to the regulated services outweigh the costs. Specifically, Austin says that a cable company should not be allowed to inflate the investment attributable to basic and expanded basic cable service tiers when it upgrades a system primarily to provide advanced, nontraditional services. Austin Comments at 3, 9-11. Continental characterizes these comments as suggesting that franchising authorities should have the right to exclude from the ratebase those investments which they feel are of insufficient benefit to all subscribers. It contends that granting that untrammeled right to franchising authorities is inconsistent with the Cable Act of 1992 and the cable industry, because if the investment needed to deliver the many niche video services (i.e., those without the mass appeal of networks such as ESPN, CNN, and USA) is removed from the ratebase, operators will have an incentive either to add niche services to a more expensive tier or not to add them at all, defeating the Act's principles of

investment standards allow into the ratebase portions of plant that directly benefit the ratepayer, and exclude any imprudent, fraudulent, or extravagant outlays.

40. We believe that adoption of this approach best fulfills our statutory mandate to ensure that regulated cable service rates are reasonable while allowing operators to earn a reasonable return on their investment, and reducing regulatory burdens.[65] The prudent investment standard strikes a fair balance between consumer and cable investor interests in that it protects consumers from subsidizing plant not prudently invested in, while allowing cable operators to recover their costs prudently invested in regulated cable service.[66] The used and useful standard ensures that subscribers pay for only those portions of plant that are used and useful in the provision of regulated cable services. The standard is also familiar to this Commission as the standard we have applied to telephone companies, and should thus be simple to apply and administer.[67] This approach will thus allow us to achieve a fair balance of consumer and investor interests in determining regulated cable service rates under our cable cost of service standards.

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expanding choice and encouraging upgrades. Continental Reply at 7. We believe that the accounting and cost allocation rules we adopt today adequately address these concerns.

[65] Communications Act, § 623, 47 U.S.C. § 543.

[66] See Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944) (Hope); see also American Telephone and Telegraph Co., 64 FCC 2d 1, 47 (1977).

[67] The Commission has traditionally applied the prudent investment and used and useful standards to communications common carriers under rate of return regulation. See Amendment of Part 65 of the Commission's Rules to Prescribe Components of the Rate Base and Net Income of Dominant Carriers, Report and Order, 3 FCC Rcd 269 (1987); American Telephone and Telegraph Co., 64 FCC 2d 1 (1977), recon. in part, 67 F.C.C.2d 1429 (1979); and American Telephone and Telegraph Co., 9 F.C.C.2d 30 (1967). For a discussion of basing utility rates on used and useful assets, see Reagan v. Farmer's Loan and Trust Co., 154 U.S. 362 (1894); Stone v. Farmer's Loan and Trust Co., 116 U.S. 307 (1886); and Munn v. Illinois, 94 U.S. 113, 134 (1877). For a discussion of the valuation of used and useful assets as net investment in plant and property, see Los Angeles Gas and Electric Co., v. Railroad Comm'n of California, 289 U.S. 352 (1933); Simpson v. Shepard (Minnesota Rate Cases), 230 U.S. 352 (1923); and San Diego Land and Town Co. v. Nat'l City, 174 U.S. 739 (1899).

2. Valuation of Plant in Service

41. In the Notice the Commission proposed establishing standards to determine the value of plant in service that cable operators may include in the ratebase.[68] We requested comment on various approaches to determining the value of plant included in the ratebase, including: market value, original cost, replacement cost, reproduction cost, or a combination of these approaches.[69] The Commission noted that under applicable judicial precedent, regulators have wide discretion to select a methodology for purposes of valuating ratebase, provided the end result is reasonable, and that we would select the approach that best implements our balancing of goals for cost-based rates of cable service.[70]

42. We also solicited comment on how each methodology would affect systems under original ownership and those that have been refinanced or rebuilt. Furthermore, we sought comment on whether we should adopt one valuation methodology for determining initial regulated rates under a cost-of-service showing and another for assessing proposed increases in rates of regulated cable services under subsequent cost-of-service showings.[71] We tentatively concluded that the Commission should adopt an original cost methodology to determine the value of a cable operator's plant in service for ratebase purposes.[72]

a. Market Value

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[68] Notice at ¶ 33.

[69] Id. at nn.35-38.

[70] Id. at ¶ 33. See Duquesne Light Co. v. Barasch, 488 U.S. 299, 310 (1989); Hope, 320 U.S. at 602.

[71] Notice at ¶ 33. Because we anticipate no 'subsequent' cost-of-service proceeding for at least two years after the effective date of rates set in a cost-of-service proceeding, we defer consideration of the issue of whether we should adopt a different valuation methodology for assessing proposed rate increases under subsequent cost-of-service showings until after our adoption of final rules here. Although we see no need for separate methodologies for subsequent showings, and no party here has made an argument in support of such separation, we will be better able to evaluate this question after completion of the industry-wide cost studies initiated in this proceeding.

[72] Id. at ¶ 35.

43. In the Notice we said that under the market value approach to valuation of plant, plant in service would be valued at the fair market value of assets at the time they are acquired.[73] Several cable operators argue in favor of a fair market value approach to valuating plant.[74] These operators argue that this approach is administratively easy -- that valuation will be readily ascertainable because cable systems are often sold at market value.[75] It should be noted, however, that operators supporting a market value approach favor differing methods. For example, CATA argues in favor of a current market value approach to ratebase.[76] Others think that valuing cable assets at their actual market value as of the date of regulation might reflect capitalized monopoly profits.[77] As an alternative approach, these parties advocate a competitive market value, under which assets of the cable operator would be valued according to their actual market value, less any quantifiable capitalized monopoly profits.[78]

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[73] Id. at n.35.

[74] See, e.g., Comcast Comments at 29-30; Medium Operators Comments at 2 (asserting that cable operators have a constitutional right to earn a fair return on the present market value of the system and, therefore, the Commission must adopt a market value approach); NCTA Comments at 10; Comcast Comments at 11-12; COA Comments at 67; COA Reply at 31.

[75] See, e.g., Comcast Comments at 11-12; CATA Comments at 14-15 and Attachment at 22 (arguing that use of this approach will produce the greatest value for subscribers, reward management efficiencies, permit recovery of upgrade costs, and promote the efficient acquisition and transfer of cable systems).

[76] CATA Comments at 14-15. CATA specifically argues that market value should approximate reproductive cost of service (or replacement cost of service, depending on technological innovation) because it encompasses everything in the going concern, including recovery for superior management and other assets important in determining a firm's value. CATA Comments, Attachment at 24.

[77] See Cablevision Industries Comments at 31.

[78] Id. See also Viacom Comments at 14, 15, 33, 36-39, and Attachment at 18-27; Time Warner Reply at 2 and Appendix at 4-5. This approach requires that the percentage of a cable company's value that represents monopoly profits be determined through an "event study" which tracks the stock market response to passage of the Cable Act of 1992 and benchmark regulation. Cablevision

44. Several parties argue against the market value approach. For example, Bell Atlantic argues that this approach is flawed by its inherent circularity because in a regulated environment market value is the result of regulation, rather than the starting point.[79] Austin argues that one should not rely on the market value of cable systems for determining ratebase because prices paid for systems are based on expected revenues, regardless of whether these expected revenues are based on reasonable rates.[80]

b. Original Cost

45. Original cost was defined in the Notice as the initial construction cost of the property, adjusted for all subsequent capital transactions including depreciation, retirements, and improvements.[81] Numerous parties, including local and state governments and telephone companies, support an original cost approach.[82] Bell Atlantic suggests that the Commission use original cost, less depreciation, to determine rates for both the original owner and subsequent purchaser.[83] Some parties support the use of original cost, arguing that using original cost will permit the operator to recover the costs of constructing the plant that is used and useful in the provision of regulated cable service, and will produce the lowest rates for consumers.[84] Bell

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Industries Comments at 31.

[79] Bell Atlantic Comments, Appendix at 16.

[80] Austin Reply at 12.

[81] Notice at n.36.

[82] See, e.g., Michigan Committee Comments at 13; Municipals Comments at 19; Seaford Comments at 11; Utah Comments at 13; GTE Comments at 21; New Jersey Comments at 6; Bell Atlantic Comments at 22 and Appendix at 16; New York Comments at 5; see also ETC Comments at 3.

[83] Bell Atlantic Comments at 22 and Appendix at 16. Comcast argues against this approach because it could exclude 90 percent of the invested capital for cable systems which were sold in the late 1980s. Comcast Reply, Appendix at 5, 26-27.

[84] See, e.g., Utah Comments at 14; Michigan Committee Comments at 14; Bell Atlantic Comments at 23 (adding that the Commission should adopt the same ratebase approach for the telephone and cable industries so that the cable industry does

Atlantic believes that original cost will be the easiest methodology to administer and prove.[85] But New York, which argues in favor of this methodology, warns that original cost may be difficult to determine, because of the frequency of cable system turnover.[86]

46. Small Systems argues in favor of original cost if the Commission adopts the definition found in AT&T v. United States, "the actual money cost of (or the current money value of any consideration other than money exchanges for) property at the time when it was first dedicated to public use, whether by the accounting company or by a predecessor public utility."[87] Small Systems states that for an original owner, the original cost of the system should not be difficult to determine, and that where original cost information is not available, the Commission should use reproduction cost.[88]

47. The majority of cable operators argue against the original cost approach.[89] Two operators argue that use of this

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not gain an unfair advantage). Small Systems agrees that the original cost approach is fair, as long as operators are also permitted to recover their other, unrecovered costs such as start-up expenses, budgeted capital expenditures, interest, and deferred depreciation. Small Systems Reply at 16, 18-19.

[85] Bell Atlantic Comments at 22-23. Austin agrees, arguing that even if, as the industry claims, there is a lack of records documenting original cost this can be taken care of on a case-by-case basis, using the net book value for tangible assets or industry-wide data for comparable systems. Austin Reply at 19.

[86] New York Comments at 5.

[87] Small Systems Comments at 10, citing AT&T v. United States, 299 U.S. 232, 242-243 (1936). See also Viacom Comments at 16-21; Cablevision Systems Comments at 17, 30 (under this approach, for all cable systems acquired prior to regulation, original cost would be the current operator's net acquisition cost, thereby eliminating the concept of excess acquisition costs). This approach does not comport with our definition of original cost and is accordingly deferred to discussion in 'Other Approaches,' part III.A.2.d., infra.

[88] Small Systems Comments at 10, n.13.

[89] See, e.g., Avenue TV Comments at 2; BC Comments at 10; CATA Comments at 14; COA Comments at 52; Georgia Cable Comments at 18; Eagle Comments at 3; Medium Operators Comments at 6-8;